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SUBJECT: LESOTHO JULY 2007 ECONOMIC ROUNDUP: GOOD FISCAL POLICY BUT SLOW GROWTH

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¶1. SUMMARY: While Lesotho's growth rate remains troublingly low, the GOL's fiscal discipline has allowed the country to keep inflation under double digits, maintain sizable foreign currency reserves, and run a public sector budget which is strongly in the black. On the good news front, the World Bank recently approved credits for Lesotho's Private Sector Competitiveness Project, which will compliment the Millennium Challenge Corporation's (MCC) efforts in this arena. The GOL's recent monetary operations have been successful. However, uncertainty surrounding the future of SACU transfer payments highlights the need for the GOL to continue to diversify its revenue base. END SUMMARY.

Private Sector Competitiveness Projects

¶2. In June, the World Bank's Board of Directors approved a credit of $8.1 million for Lesotho, $4.2 million of which is a grant to support the GOL's Private Sector Competitiveness and Economic Diversification Program. The aim of this program is to create an enabling environment for private sector development. Approximately 41.6% of this project's cost will be covered by the World Bank grant, 38.6% will be covered by concessional financing, and the rest will be allocated from the GOL's budget.

¶3. The project will target impediments to growth and job creation, focusing on reducing the cost of doing business, developing a skilled workforce, and providing loan guarantees to help small- and medium-sized enterprises to access capital commercially. The project also aims to develop a regulatory framework for the leasing industry. These efforts should dovetail with the $36.1 million Millennium Challenge Account program in the field of private sector development, which will focus on capacity building, civil and legal reform, land administration reform, and payment clearing and settlement systems.

Weak GDP Growth, Agricultural Collapse

¶4. GDP growth remains weak at just 2.9%, comparing negatively to the regional average of 5.3%. This sluggish economic performance is reflected across all sectors of the economy.

Diamond mining has become the second largest contributor to growth (after textiles and clothing). However, the mining sector's growth rate declined by 48.2% compared to last year, when the opening of a new mine in Liqhobong and early finds of world-class diamonds helped create high growth numbers. The manufacturing sector recovered following the 2004 expiry of the Multi-Fiber Agreement, but its growth has now slowed to 11% largely due to strength of the rand against the dollar (the rand has appreciated more than 4% since March). Agricultural production was hard hit by drought, resulting in a projected 47% production decrease and serious food insecurity (reftel).

Strong Fiscal Policy

¶5. The GOL's healthy government finances reflect strong growth in tax revenue collection, leading to a fiscal surplus equivalent to 6.5% of GDP. South African Customs Union (SACU) transfer payments to Lesotho remain buoyant as result of an adjustment in the formula used to calculate such payments. These SACU transfers currently account for 62% of GOL revenue. While these transfer payments from SACU will likely increase further in FY 2008, they are expected to decline in subsequent years. Government expenditures remain huge, totaling 53.5% of GDP -- 80% of which are recurring expenses. And the government's share of the total economy continues to grow -- the government's wages bill and other non-interest current expenditures increased by 1% and 3.8% of GDP respectively in the last year.

Inflation Indicators and Monetary Policy

¶6. Growth in M2 (cash in circulation plus net time deposits), often an indicator of price pressures in the economy, increased by 5% between May and June. The overall Consumer Price Index (CPI) registered 7.9% in June, and sizable price increases were observed in the indices for food, non alcoholic drinks, and energy. Inflation currently appears under control and does not threaten the rand/maloti relationship; however, leading indicators such as M2 growth indicate that it could be cause for concern in the medium term. Sustained inflation over the past five years (averaging over 9 percent) has eroded purchasing power for most wage earners

¶7. Recent monetary operations have successfully maintained rand/maloti parity. Lesotho's Net International Reserves (NIR) are currently a healthy $715.862 million, exceeding the GOL's target of $450 million by 59% and providing five to six months of import cover. This above target performance on international reserves is due to recent diamond and textile sales and the continuing SACU revenue windfall.

Dangers Down the Virtuous Road

¶8. COMMENT: While Lesotho strode down the virtuous road of balanced budgets and high foreign currency reserves, healthy GDP growth did not follow. Optimists hope that programs such as the MCA Compact and World Bank sponsored private sector development initiatives can rectify this injustice. Lesotho's current macroeconomic position indicates that policy challenges face Lesotho. Transfer payments from SACU will decline, and the high current levels of government spending based on this source of financing poses a serious risk to government fiscal

sustainability. Continued improvement in tax collection and other means to diversify the GOL's revenue base seem the most logical and constructive escape route from this impending problem. END COMMENT.
MURPHY